

Springtime for Digital Health: It's not Always Rainbows and Butterflies, it's Compromise that Moves us Along

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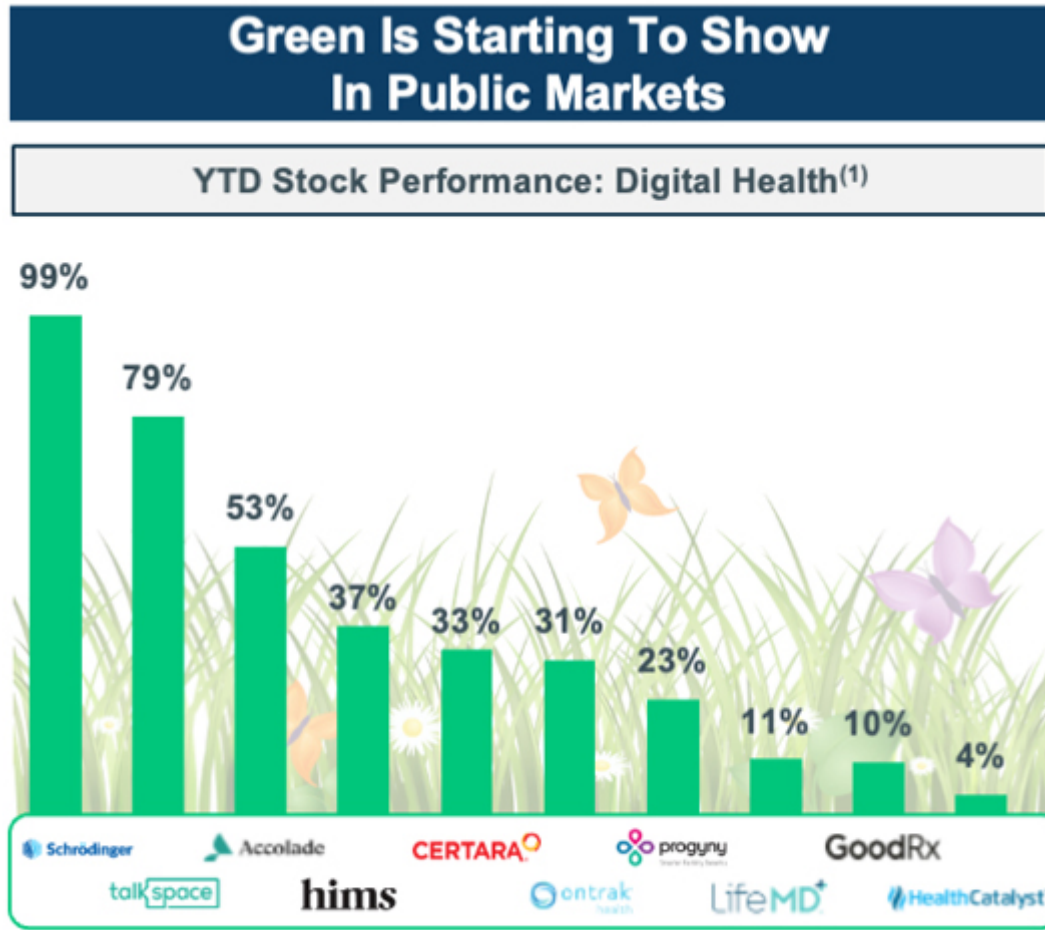
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Spring is a time for new beginnings. Before looking ahead, we must take a moment to reflect on the SVB implosion in March and the ensuing banking crisis. SVB was a beacon for the innovation economy. It was an 'n of 1' financial institution and the backbone for innumerable companies and investors. The disruption hit hard, and it was painful – a weekend of existential risk experienced by thousands of CEOs, CFOs, and boards. It all still seems so surreal and unnecessary. The storm has calmed for now, and those committed to positive change in healthcare, technology, and all corners of the innovation economy are back at it. Anxiety remains as we remember the 'lull' in the Financial Crisis between the Bear collapse in March 2008 and the Lehman bankruptcy six months later. Still, we remain optimistic that we see light flickering on the other side of this tunnel, which is now over two years past the peaks of the Digital Health boom.

During the first quarter, markets experienced volatility as investors and companies dealt with continued headwinds from inflation, high interest rates, and the banking crisis. Despite the environment, the Digital Health sector started to demonstrate resiliency, trading up 13.1% in the YTD period (vs 7.2% for the S&P)^[1], as many notable names posted double digit gains. Valuations remain at meaningful discounts to 2021 highs but appear to have stabilized with the sector trading ~3x^[2] on average for the past year. Path to profitability remains the focus area for investors across both public and private business. Companies able to deliver both growth and profitability are capturing market interest, with 'Rule of 40+' names trading at more than 200% premium to other names across the Digital Health sector. While financing activity in Digital Health remains below levels experienced in recent years, 1Q23 posted the first QoQ increase in more than a year. Moreover, mega financings over \$100mm started to return. Similarly, the M&A market has started to show signs of life with rising deal volume in the quarter as strategic acquirors lead the way. While the market remains challenging for financing and deal activity, the 'green shoots'

experienced in Q1 represent the first positive trends experienced in more than a year. The slow, but steady thawing of the market is marked by rising levels of investor dry powder, high demand for new capital, and a narrowing bid/ask between investors/buyers and companies. The stage is set for interesting times ahead.

Digital Health Stocks Return to Positive





Source: Factset

After two years of decline in share prices, many notable Digital Health stocks have begun to post meaningful gains. As public investors leaned into a 'risk-on' stance to start the year, the companies across the Digital Health sector have benefited. They are outperforming the broader market with the Digital Health sector up 13.1% vs 7.2% for the S&P. Several of the companies that experienced the steepest declines during the last two years are those that have rebounded to outperform. With Digital Health public market valuations continuing to trade at a meaningful discount to longer-term averages (and at an 80% discount to peak levels), there remains meaningful runway for additional gains across the Digital Health public company universe.

Key Takeaway:

While the Digital Health sector may not have a clear and straight path to recovery given idiosyncratic operational underperformance and the continued 'choppy' market conditions, selected companies' gains during 1Q23 have provided promising signs of life following nearly two years of melting down.

Digital Health Companies are Prioritizing Profitability

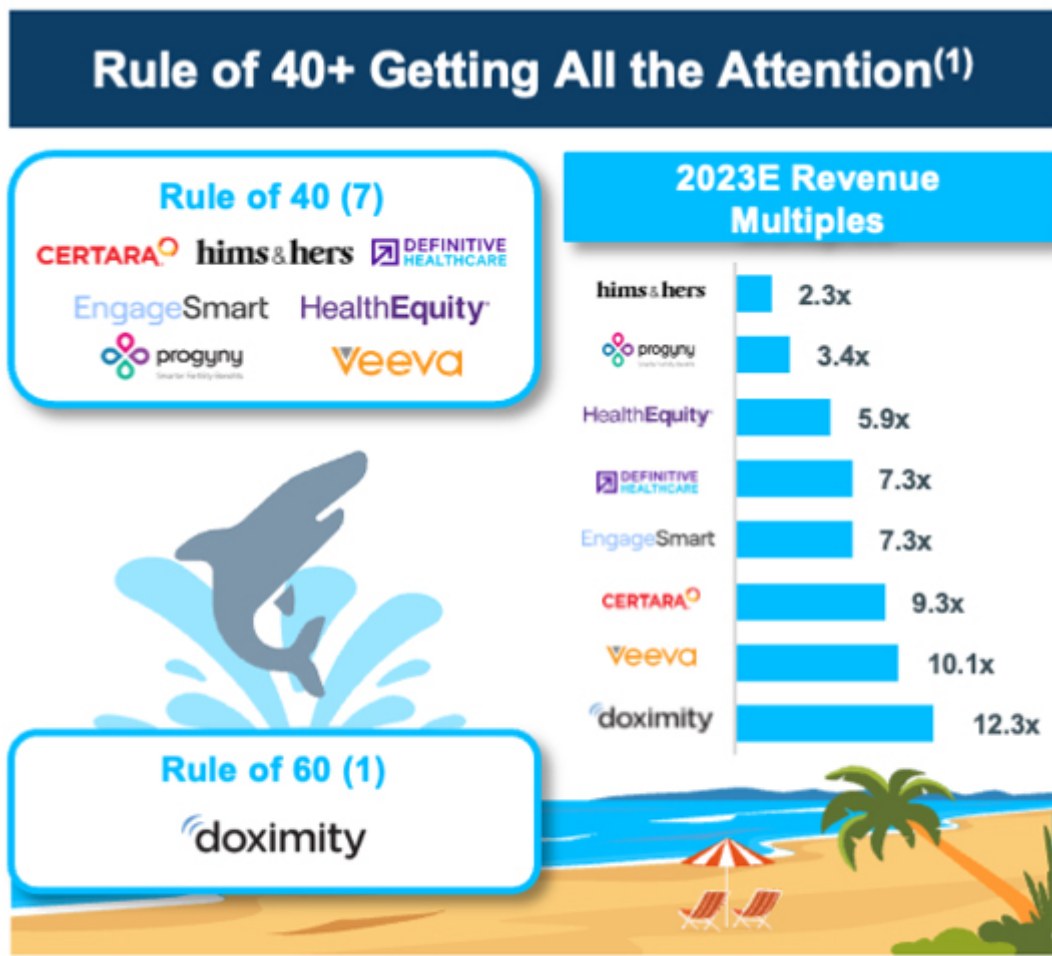
Getting in Shape for the Summer – <i>ebitda...so hot rn</i>	
Company	EBITDA Improvement +
 Accolade	Stable annual EBITDA improvement, breakeven projected by '25
 HealthCatalyst	EBITDA beat Q1, FY 2023 adj. EBITDA positive
 hims	Hitting inflection point for company's operational cash flow
 Phreesia	Approaching breakeven adj. EBITDA with return to profitability in FY 2025
 progyny <small>Greater Fertility Outcomes</small>	Meaningful strides towards long term cash flow profitability

Source: Factset, Company Earnings Releases & Transcripts

As referenced in our previous market update, Digital Health companies have faced pressure from both public and private investors to reorient their business models and rein in costs as the focus turns to profitable growth rather than growth at all costs. Commentary and results from public

Digital Health companies during 1Q23 highlights this shift in focus, as several prominent names emphasized their progress on their paths to profitability. Both Health Catalyst and Hims will deliver positive EBITDA results for the first time ever during 2023 with many other notable companies expecting to cross over breakeven EBITDA in the coming two years. Given the uncertain financing markets and the increasing emphasis on profitability by investors, reducing cash burn, and accelerating the path to profitability will be paramount for companies to survive and thrive coming out of this downturn. Investors are closely tracking commentary and results as it relates to profitability targets and execution. Business models without proven unit economics and a demonstrable path to profitability will likely be left with difficult choices as investors have shown less appetite for funding perpetual cash burn in the current environment.

‘Rule of 40+’ Companies are Returning to Focus



Source: Factset

Consistent with the focus on profitability, the 'Rule of 40+' differentiator is clear – where the sum of a company's revenue growth rate plus its EBITDA margin exceeds 40%. Companies able to exceed the Rule of 40+ threshold are trading at a premium to other companies in the Digital Health sector. Importantly, the way they get there matters as profitability is a more important element in the equation versus two years ago. Of the seven public Digital Health companies currently trading in excess 5x revenue, six are Rule of 40 members with positive EBITDA margins. Additionally, the only three companies in Digital Health currently trading at multiples greater than 10x revenue have the highest three Rule of 40+ metrics in the sector and deliver EBITDA margins of more than 35%. This increased correlation between 'Rule of 40' members and valuation underscores investors' shift in focus to reward profitable growth. The highest valuation, and steady in her reign since IPO, remains Doximity, the only Rule of 60+ company in Digital Health and the closest thing we have to a SaaS wunderkind.

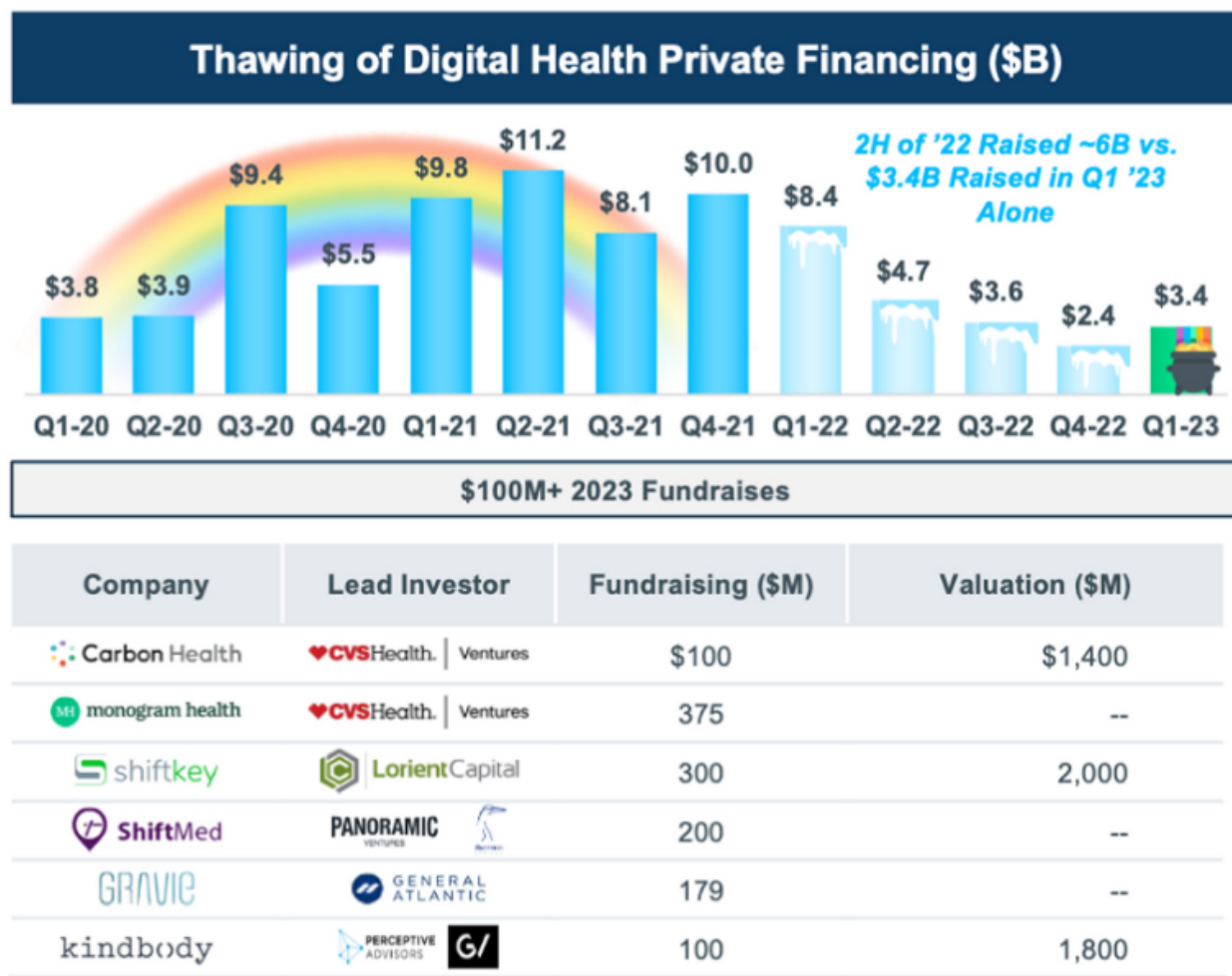
Key Takeaway:

After a challenging year in Digital Health in 2022 with many companies having to make difficult decisions to reshape their cost structures, the market is clearly rewarding those who demonstrate profitable growth.

Digital Health Financing Market is Beginning to Thaw

Financing activity across the Digital Health sector increased 40% in 1Q23 (totaling \$3.4bn vs \$2.4bn in 4Q22), reversing a recent trend of four consecutive quarters of declining activity. Funding in the quarter still remains below levels during 2020-2021, but importantly represents one of the first positive developments for the sector in more than a year. Additionally, multiple \$100M+ financings have occurred this year. Similar to 2022, strategics and insiders have been key participants for these larger financings, but notable new sponsor-led deals have also occurred including deals for Gravie and Kindbody, among others. While there remains a gap in the bid/ask spread between companies' expectations and investor appetite, that gap is beginning to narrow which helped facilitate an uptick in activity for the quarter. Investors remain cautious in deploying new capital, particularly for high cash burning companies. However, increasing levels of dry powder

and moderating valuation expectations are bringing investors back to the table. Overall activity will likely remain modest in near-term (relative to peak 2021 levels) as inflation and recent banking turmoil has tempered recovery momentum.

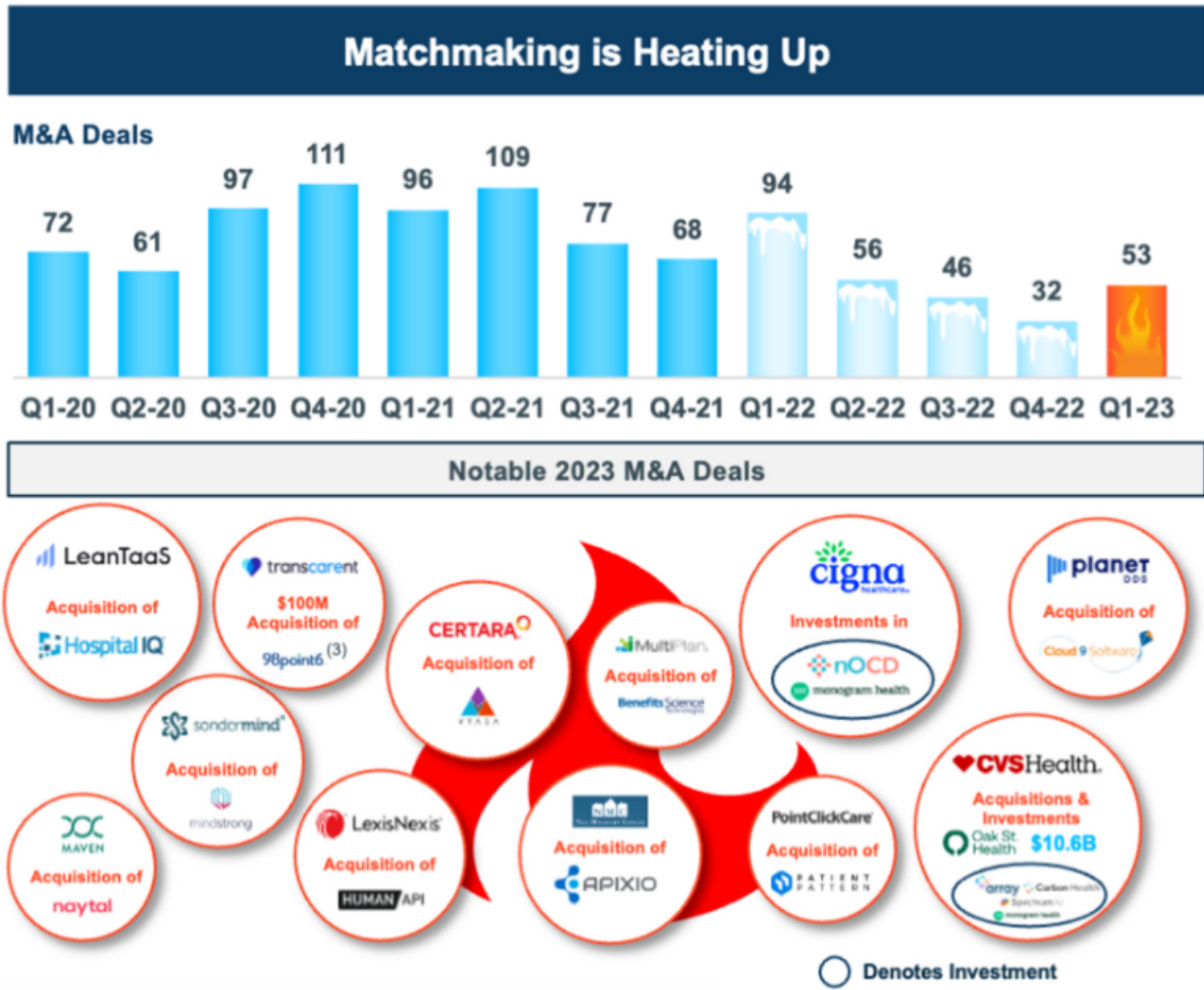


Source: Rock Health Digital Health Venture Funding, Company press releases

Strategic Activity Driving up M&A in Digital Health

Similar to the Digital Health private financing market, M&A deals across the Digital Health sector increased for the first time in more than a year as deal volume jumped 66% in 1Q23 (53 deals in 1Q23 vs 32 deals in 4Q22). Large strategics have continued to be active in capitalizing on opportunities that closely align with their stated key priorities. CVS Health's \$10.6bn of Oak Street Health represents an example of this as the acquisition fulfills one of CVS' well publicized objectives to expand its primary care capabilities and assets. Additionally, given the challenging

financing and valuation environments, Digital Health companies and investors are increasingly considering merger opportunities. Private mergers with stock as meaningful part of the consideration are becoming increasingly attractive as Digital Health companies look to build scale, accelerate their path to profitability and better position themselves as markets begin to recover.



Source: SVBS Digital Health M&A & Fundraising Database, Company press releases

Key Takeaway:

While far from the booming markets experienced during 2020 and 2021, the Digital Health sector saw both financing and deal activity increase to start the year, as markets have started to thaw. Still, broader economic headwinds, namely high inflation and banking sector challenges hampered the progress towards recovery for Digital Health. Many companies across Digital Health remain in challenging positions given the limited capital availability for cash-burning companies. A stabilizing valuation environment should continue to support modest levels of financing and acquisition

activity.

Conclusion:

After overcoming a challenging year in 2022, the first quarter provided multiple green shoots of activity across Digital Health. The SVB black swan dive put a damper on those who rely on the twin crutches of grit and optimism. We take solace in the numbers. Financings and M&A activity for the quarter both trended up for the first time in more than a year, as a reversion to the mean supports levels in line with those of 2019. We can turn back to first principals as the market continues to reward profitable growth. A credible path to profitability is critical for those burning cash. Our oldest and closest friends, strategics and insiders, remained important sources of capital for the quarter.

May we live in interesting times.

[1] Based on market data as of 05/24/2023 from Factset

[2] Represents median NTM multiple

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